

## IMPACT OF CHINA'S U.S. DEBT HOLDINGS ON U.S. SOVEREIGN POWER

BY

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by

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## **ABSTRACT**

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The U.S. national debt is the top national security issue facing the country today. In the past ten years, the U.S. debt spiraled to record heights and has largely been funded by China's purchases of U.S. Treasury securities. The creditor-debtor relationship between the U.S. and China calls into question the future of U.S. foreign policy independence. This paper assesses the likelihood and effectiveness of China using its debt holdings as leverage against U.S. foreign policy. This leverage is believed to be low because the impact to China itself is significant and such action would be counter to its economic growth strategy. Nonetheless, the scale of the U.S. debt and its projected growth requires action. The U.S. must take aggressive steps to reduce its debt. Additionally, it must temper its penchant for deficit spending to mitigate the risk of constraints on its foreign policy and more importantly to restore the foundations of U.S. power.





## IMPACT OF CHINA'S U.S. DEBT HOLDINGS ON U.S. SOVEREIGN POWER

A nation's power grows as much from its economic strength as its military strength. Though the U.S. remains the largest economy on the planet, recently, China has overtaken Japan as the world's second largest economy. It is on a growth rate which, should it continue, would make China's economy the largest world economy in less than twenty years. The relative economic strength of U.S. and China is further complicated by China's large U.S. debt holdings, causing many countries to question the U.S.'s ability to maintain continued world influence. Many scholars see "the erosion of America's power as a result of its indebtedness."<sup>1</sup> This paper explores the relationship between the financial interdependence of the U.S. and China as it impacts sovereign power.

### The U.S. National Debt

The U.S. is experiencing a period of historically high government debt that, as a percentage of Gross Domestic Product (GDP), has not been seen since World War II (WWII). As if to celebrate the New Year, the U.S. debt in real terms surpassed the \$14 trillion mark as the calendar year of 2011 began.<sup>2</sup> Using the fiscal year ending 2010, as a reference point, the Congressional Budget Office (CBO) has reported the U.S. debt as \$13.5 trillion or nearly 93% of U.S. gross domestic product (GDP).<sup>3</sup> Of this total, most is held publicly in the form of U.S. Treasury bonds and other securities. The same CBO report places this publicly held portion of the debt at over \$9 trillion, of which \$3.2 trillion has been added in the three years between 2008 and 2010. The historical average U.S. debt level over the last 40 years hovers around 35 percent of GDP, but in the last three

years the debt level has increased from this historical baseline to over 62% of GDP. An upward spiral in U.S. debt level is underway.

What makes the matter more troublesome is that the CBO projects the size of the debt to grow further in the coming years due to continued government deficit spending levels. Before the renewal of the Bush era tax cuts, CBO projected the debt held by the public would exceed \$16 trillion by 2020 and reach nearly 70 percent of projected GDP.<sup>4</sup> With the extension of the Bush tax cuts the same CBO report projects that the debt held by the public will grow to over 100 percent of GDP by 2020.<sup>5</sup> This means the U.S. will need to seek more loans from sources outside the U.S., increasing the risk of borrowing costs, expressed as interest rates, to increase.

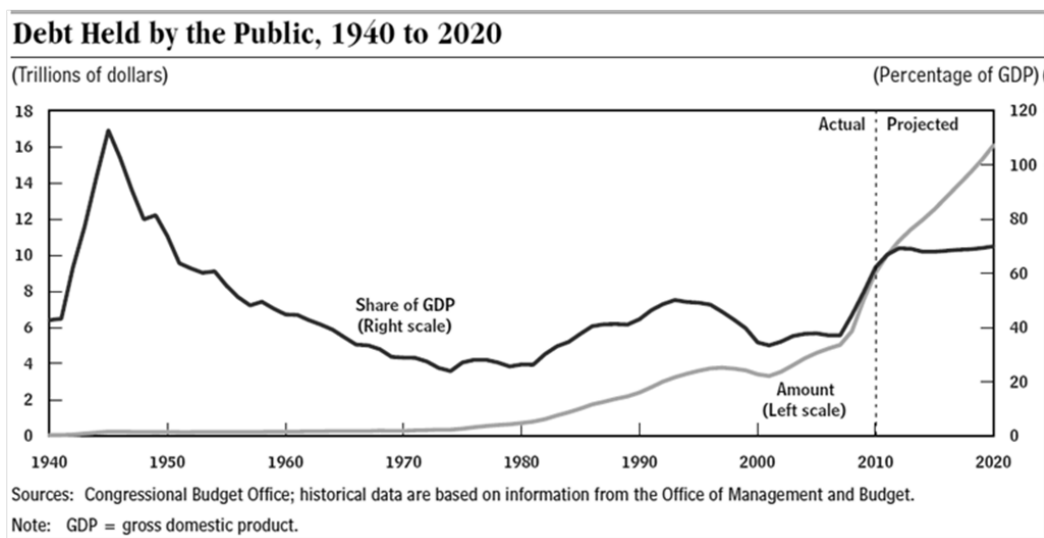


Figure 1: U.S. Debt held by the Public<sup>6</sup>

Many attribute the rapid growth of U.S. debt levels to the wars in Iraq and Afghanistan and the financial crisis of 2008. Though the spending to fund the wars in Iraq and Afghanistan and the spending to halt the financial crisis have certainly been a significant part of the increased debt levels, they are not exclusively to blame. Rather,

an imbalance between spending and revenues that predate the financial crisis has led the U.S. to this precarious position.<sup>7</sup> The Bush era tax cuts, combined with the Medicare prescription drug benefit began the debt spiral.

Not all of the U.S. debt is held publicly. There is an important distinction between total debt and the debt “held by the public.” Within the government budget, the Social Security trust fund has been employed to subsidize much of the deficit spending. For much of its existence the revenues generated by the Social Security administration have exceeded expenditures. In fact, this has been true for all years except for 2010 where the recession decreased Social Security revenues below outlays. These accumulated surpluses in the Social Security trust fund have provided an ample source of funds for the government to borrow against in order to fund other government expenditures. This practice, however, depends on the continued positive cash flow.

As U.S. demographics change with the retirement of the baby-boom generation, this positive cash flow ends. The Government Accounting Office currently estimates this transition from positive cash flow to negative will occur in 2015.<sup>8</sup> A one year instance of negative cash flow for Social Security occurred in fiscal year 2010 due to the recession, but the projection of a long term period of negative cash flow will negate this inter-governmental lending to cover future deficit spending. Therefore, the ability of the current account to borrow from the Social Security trust fund will place even more pressure on the overall federal budget.

The central banks of many countries currently hold most of the publicly held U.S. debt. Table 1 lists the top ten foreign holders of U.S. securities as of November 2010. A review of the table shows some allies or nations with friendly relations to the U.S., for

example the UK and Canada. But the table also shows the holdings of other countries with which the U.S. security relationship is more circumstance. China is and has been for several years, the largest holder of U.S. debt based securities.

The Department of Treasury report for outstanding publicly held treasury securities at the end of November 2010 reports that China holds \$1.164 trillion in U.S. Treasury securities.<sup>9</sup> This value does not include an additional \$134.9 billion held by Hong Kong, which the Department of the Treasury reports as a separate bond holder. Accounting for this, China in the aggregate, holds over 29.4% of the \$4.413 trillion outstanding U.S. securities.

Iwan Morgan, Professor of U.S. Studies and Head of U.S. Programmes at the Institute for the Study of the Americas, contends that “creditors are usually advantaged over debtors in international politics.”<sup>10</sup> Japan is the number two holder of U.S. Treasury securities with \$875.9 billion and the UK is third with another \$242.5 billion, but as traditional U.S. allies, the concern is lessened. The impact of China’s U.S. treasury and debt holdings has been suggested to signal the end of American global power<sup>11</sup> and begs the question: will the U.S. be constrained in international relations as a consequence of this creditor-debtor relationship with China?

Country	Nov. 2010
China, Mainland	\$1164.1
Japan	875.9
United Kingdom	242.5
Oil Exporters	204.3
Brazil	189.8
Russia	167.3
Carib. Bnkg. Ctrs.	159.3
Taiwan	154.4
Hong Kong	134.9
Switzerland	107.0

Table 1: Top ten holders of U.S. Treasuries (in billions of dollars)<sup>12</sup>

A historical precedent exists for such a situation. In 1956, during the Suez Crisis, the UK and France participated with Israel in the seizure of the Suez Canal from Egypt. This surprise attack caused a disruption to the flow of oil to the West and unsettled the Eisenhower administration. As a result, the U.S. pressured the UK through its large holdings of UK debt and its veto power within the IMF to withdraw from the canal zone and restore the status quo.<sup>13</sup> Today's U.S. debtor relationship with China could present a similar situation if regional security tensions place the U.S. and China in an adversarial position.

### Implications

The possibility that China might use its vast holdings of U.S. securities as leverage against the U.S. has been the source of much speculation and political rhetoric. During the last U.S. presidential election then-candidate Obama expressed concern over the creditor-debtor relationship stating, "It's pretty hard to have a tough negotiation when the Chinese are our bankers."<sup>14</sup> A 2008 report by Brad Setser when he was at the Council of Foreign Relations also expressed this concern. He said the "longer the United States relies on central banks and sovereign funds to support large external deficits, the greater the risk that the United States' need for external credit will constrain its policy options."<sup>15</sup> It is interesting to note that Setser now sits on President Obama's National Economic Council. The well known and much interviewed historian Niall Ferguson from Harvard also worries about the impact of U.S. debt to its position in the world relative to China. Ferguson regularly connects U.S. indebtedness to its eventual decline.<sup>16</sup>

The paths China could take to gain leverage from its U.S. debt holdings, is through a sell-off of U.S. Treasury securities, a cessation in the continued purchase of

such securities, or even a rumor that such continued purchase of securities was in doubt.<sup>17</sup> Would these actions be effective and what would be the impact on the U.S. and the collateral impact to China be for taking such action? Former Treasury Secretary Lawrence Summers once referred to the mutual impact a sell-off of U.S. securities would have as a “balance of financial terror.”<sup>18</sup>

The historical record of transferring sovereign creditor status to impact diplomatic and military power is more complicated than it may seem. Daniel Drezner, professor of International Politics at Tufts University, published a recent study analyzing the prospects of financial leverage creditor powers gain over debtors. He arrives at several conditions which are required for such leverage to be effective.<sup>19</sup> Drezner’s limits of financial leverage over a creditor are: alternative sources of credit; low costs of retaliation; low expectations of future conflict; and the monetary regime. A short review of his analysis follows to identify the limits to any prospective Chinese leverage over the U.S. and indicators should any such leverage conditions emerge in future Sino-American relations.

The first condition Drezner spells out for effective financial leverage over another nation is the lack of alternative sources of credit. In the case of U.S. - China relations, the fact that China holds over 29% of U.S. debt is significant but it is not exclusive.<sup>20</sup> Such leverage should it be applied against the U.S. would have to be applied in concert with other U.S. creditors. The debt holdings detailed earlier in Table 1 showed the variety of alternative sources of credit available to the U.S.; several U.S. allies also hold significant portions of its debt. Japan holds a sizeable percentage of U.S. debt as well with nearly 20%. Considering the enduring Japan – China animosity, and strong U.S.-

Japan ties, it is likely that should a U.S. borrowing crisis emerge, Japan can be relied upon as an alternative source of credit. A similar alternative source of credit exists with the other large stake holders of U.S. debt. Both the UK and Japan would likely be motivated to defend the value of their portfolios and would add to their positions to prevent losses to their holdings should China move to dump its holdings. Therefore, it is unlikely China could muster an effective global alignment to deny alternative sources of credit to the U.S.

The second condition for effective leverage of financial power is a low cost of retaliation. China would indeed pay a cost if it chose to gain financial leverage over the U.S. A significant selloff of U.S. holdings by China would result in a devaluation of the dollar against the renminbi (RMB). It is estimated that a 10% depreciation of the dollar relative to the RMB would result in a loss of 3% of China's GDP in its foreign exchange holdings.<sup>21</sup> This is an excessive cost to pay to exercise financial leverage. There might come a time China would be willing to pay such a price, but as Drezner puts it, "the interdependence makes it difficult for China to credibly threaten any substantial exercise of financial muscle."<sup>22</sup> The costs to China for a sell-off are greater than solely the loss of value in their own Treasury holdings. China's increasing levels of foreign direct investment in U.S. based companies,<sup>23</sup> further decreases any motivation to depress the value of its U.S. treasuries. The resultant impact to equity based assets would also suffer and China would be "shooting itself in the foot by dumping Treasury securities on the market for political purposes."<sup>24</sup>

The third condition Drezner cites as a requirement for effective financial leverage is the monetary regime of the creditor, in other words, whether the creditor maintains a

fixed or floating currency values. Drezner's analysis shows that a floating currency exchange rate makes gaining financial leverage over a debtor very difficult. In the case of the U.S. and China, the floating U.S. dollar makes itself resistant to a global run on the currency. It is ironic that in the U.S.-China relationship, it is China who has chosen to peg the value of its currency to the U.S. dollar. The fact that the U.S. is able to borrow in its own currency, an "exorbitant privilege," as the French finance minister for Charles de Gaulle once called it, provides additional buffer to any financial statecraft. Chin and Helleiner, both academics and Senior Fellows at the Centre for International Governance Innovation at the University of Waterloo, echo Drezner's description of the exchange rate risk to China should they seek to use its creditor status as leverage. Because its exchanges are denominated in U.S. dollars, China is part of the dollar bloc and is in a "dependent position" as a result of protecting the value of its dollar based assets.<sup>25</sup> So this condition does not exist in the U.S.-China relationship.

To summarize, Drezner assesses that "target state must be unable to find alternative creditors, lack the capability to inflict costs on the sanctioning country...anticipate few conflicts ...over time, and try to maintain a fixed exchange rate regime"<sup>26</sup> for financial leverage to be effective. These conditions do not exist currently between the U.S. and China. It is important for U.S. leadership to monitor these conditions to prevent such financial vulnerability from emerging in the future.

Therefore, the U.S. should not fear China's threats to cease purchasing U.S. Treasuries in the short term. China has too much at stake with the scale of its holdings and there are no true alternative markets in which China can invest their large exchange surpluses. The dollar remains the world's principal currency, because of "the lack of a



viable substitute as because of global confidence in American economic dependability.”<sup>27</sup>

The primary alternative to the U.S. dollar for China’s large exchange holdings is the euro. The euro has emerged as a globally traded currency. However, the sheer scale and tradability of the euro compared to the dollar is in doubt. Recent Congressional testimony at the U.S.-China Economic and Security Review Commission revealed that a transition to the euro as a replacement to the U.S. dollar is simply not feasible.<sup>28</sup> The primary reason is the insufficient circulation of the euro in international transactions. The dollar provides 62 percent of all reported currency reserves compared to 27 percent for the euro. A distant third alternative to the dollar - the Japanese yen consisted of just 3% of all currency reserves. Noted Economist, Eswar Prasad, recently agreed with this assessment at a Congressional hearing on the U.S.-China financial interdependence. Though he noted some debate over the scale of costs the Chinese would incur in moving away from U.S. Treasuries, he did reinforce the point that “there are few relatively safe investments other than U.S. government bond markets that are deep and liquid enough to absorb” China’s massive funds.<sup>29</sup> The fact that the U.S. has never defaulted on a loan and the uncertainty of alternatives for risk-averse Chinese central bankers makes any threat of China leaving the U.S. securities market highly unlikely.

A second consideration against a transition away from the dollar to the euro is evidenced in the recent financial strife in the European Union. Ireland’s recent EU bail-out follows Greece’s financial problems which are “leading many to question whether the euro can survive.”<sup>30</sup> Additionally, as recently as 2009, Jean-Claude Trichet,

President of the European Central Bank, contended that the euro is not set to “replace the dollar as the international reserve currency.”<sup>31</sup> China has begun to decrease its holdings and seek diversification into other assets, specifically, shares of U.S. companies.<sup>32</sup> But even these transactions are based in U.S. dollars and deepen the relationship between the U.S. dollar and China’s extraordinary trade surpluses. Given the lack of a viable alternative to the dollar, China will continue to purchase U.S. securities or other dollar based equities.

The recent tension between the U.S. and China over arms sales to Taiwan bears this reality out. The February 2010 sales of over \$6.4 billion in arms was vigorously denounced by the Chinese government and resulted in a break in military to military ties. It even elicited some calls by Chinese military leaders that retaliation might include financial measures. Maj. Gen Luo Yuan and others on state-controlled news sources internal to the country called for a sell-off of U.S. securities to weaken the U.S. and thereby the use of China’s holdings of U.S. debt as leverage.<sup>33</sup> Externally, however, a director of Chinese foreign exchange holdings, Yi Gang, assured markets that China “does not want to politicize purchases of U.S. Treasury bonds” and that China will continue to purchase them.<sup>34</sup> Obviously China saw even the threat of pulling out of U.S. Treasuries as counter to their interests.

China’s continued purchases of U.S. Treasuries are essential to China’s overall industrial policy and its export-based economic strategy.<sup>35</sup> Beijing’s U.S. Treasuries serve to maintain high growth by fostering exports and investment.<sup>36</sup> This growth strategy is critical to not only China’s rise, but also to China’s Communist Party’s (CCP) hold on power. Given China’s demography, rapid urbanization and widespread poverty,

“the Communist Party feels that it must produce economic growth to stay in power.”<sup>37</sup>

Any cessation in the growth of China’s economy would result in a growth of unemployment which would result in unrest and threaten the legitimacy of the Communist Party. Economic conflict with the U.S. would threaten its export-driven economy; therefore China is not explicitly competing with U.S. economic power.<sup>38</sup> “The Chinese Communist Party has learned the lesson of the Soviet Union’s fall: It knows its hold on power depends not on rivalry with the United States...but on whether it can deliver public goods to its people.”<sup>39</sup>

Continued export-led growth, which requires continued positive balances of trade with the U.S., is critical to Chinese government legitimacy. Further, any “retaliation from the U.S., in the form of trade impediments, could hurt China’s economy even more, since the Chinese government’s ability to provide jobs for Chinese workers depends on access to U.S. markets.”<sup>40</sup> So “Washington should not worry much about Beijing’s financial foreign policy.”<sup>41</sup> The U.S. may rely on a continuation of China’s economic growth strategy for the foreseeable future. According to Rosemary Foot, Professor of International Relations at Oxford, “fears about major shifts in Chinese economic policies, however, are overstated.”<sup>42</sup> It is remarkable to consider that China may be as addicted to its export-driven economic growth strategy, as the U.S. is to its borrowing to maintain its consumption level. Retaining legitimacy and maintaining stability compels the Chinese government to continue the investment in U.S. Treasuries that has fueled their export-led economic growth.

China’s remarkable economic growth fueled its creditor status. The emergence of China as an economic and financial power may also translate into leverage in

international affairs. However, China's rising creditor status has shown limits in its ability to influence global economic and financial systems. Similar to the Japanese economic growth in the 1980's, despite the massive holdings of foreign exchange, China is constrained by the structure of the international financial system, which is linked to the U.S. dollar as the de facto global currency<sup>43</sup>. This dependence on the U.S. dollar has left China vulnerable to risk of any exchange rate change which would devalue their U.S. holdings. To effectively influence the international system, a country can use its power to alter the rules of the international system. The U.S. has largely set the rules of the game in international economic policies as evidenced by its possessing the de facto currency, but also by establishing and fostering the growth of many of the international economic establishments. The World Trade Organization (WTO) and the International Monetary Fund (IMF) were largely creations of U.S. policies in the wake of WWII. Even the recent expansion of the G7 to the G20 was inspired by U.S. policies and leadership. China has benefitted from these international economic institutions and the arrangements that followed WWII. China has not shown an inclination to change these institutions; rather they are more and more eager to participate in them.<sup>44</sup> So "economic considerations make China a champion of the status quo not a challenger to it."<sup>45</sup>

It is important to place the rapid economic growth of China's economy and the corresponding increase in China's national power in perspective. Many analysts predict that given recent growth rates, China's economy is being projected to surpass the U.S. economy, in GDP terms, by 2027. However, even if China's economy exceeds the U.S. in GDP terms, these same linear predictions delay China's relative growth in GDP per capita until the middle of the century.<sup>46</sup> Although the GDP of China has grown

exponentially in the past twenty years and has overtaken Japan's GDP as second in the world, China's GDP per capita still indicates a large undeveloped countryside and unsophisticated economy. According to the World Bank, China's GDP in 2009 was \$4.9 trillion which is over twice its size 5 years ago.<sup>47</sup> But with its large population, this equates to only \$3600 in GDP per capita. The same measures for the U.S. are \$14.2 trillion in GDP with a GDP per capita of \$47,240.

China has a significant challenge in raising the overall quality of life of its massive population while diversifying its economy. With income disparities, 100 million people living on less than a dollar a day, urban overcrowding and a quarter of the population lacking access to clean drinking water, China faces huge internal development challenges.<sup>48</sup> China recognizes this challenge and the time that will be required to meet them. Beijing will remain "preoccupied with lifting its huge rural population out of poverty."<sup>49</sup> As long as widespread poverty persists, its principal focus will be inward to its people and raising the sophistication of its economy rather than outward.

Therefore, even given the growing scale of China's economy and its corresponding growth in power relative to the U.S., the U.S. will not lose power in the region. A rise in China's financial power need not accompany a decline in American financial power and indeed a decline U.S. financial and economic power would risk China's financial and economic power. Such a decline is counter to China's interests. The economic competition between the U.S. and China is not and should not be considered as a zero-sum situation. "China's international influence will continue to grow, above all in East Asia, but not so rapidly as to displace the United States."<sup>50</sup> And further it with continued engagement in forums such as the G20, cooperation is as likely

as competition. China now has “overwhelming economic reasons to seek a political modus vivendi with America.”<sup>51</sup>

#### Policy Recommendations for U.S. Leadership

The much ballyhooed threat of the Chinese government using its debt holdings over the U.S. to gain leverage in international affairs is unlikely. The political expediency of framing China as a loss of U.S. power does not weigh up to the substance behind the argument. As indicated, any leverage that China could attempt to exercise from its U.S. debt holdings is not likely to be effective. Further, the complex interdependence of U.S. and China’s economies imposes severe costs to China should they attempt to exercise any such leverage with a securities sell-off or even threat thereof. Although China is certainly rising economically, making a relative decline in U.S. power inevitable, the U.S. remains the dominant economic player internationally. China is nowhere near a peer competitor today and will not be that peer in the next two decades.

These facts, however, do not imply that the U.S. can neglect the size and impact of its debt and recurring deficits. Continued U.S. leadership in international affairs requires improved fiscal responsibility at home for three dominant reasons. First is to reduce the already low risk of any unlikely Chinese actions to attempt to gain leverage over U.S. interests through its debt holdings. As indicated above, the likelihood of such an adverse action by China is unlikely. However, the impact to the U.S. and the global economy would be severe. Indeed, should the Chinese government feel its hold on power is threatened, China might consider such a gamble regardless of the harm to its own economy. Given such an unlikely but severe situation “Chinese central bankers could prove to be more dangerous than Chinese admirals.”<sup>52</sup> And the U.S. “could find its options in dealing with China with regard to Taiwan or North Korea constrained by its

dependency on Beijing's continued purchase of its treasuries."<sup>53</sup> Even Drezner, who insists the influence of financial statecraft against great powers is only limited in its use, agrees that with increases in deficit spending, the U.S. China interdependence could shift from mutual dependence to an asymmetric dependence and the U.S. government would be forced to "choose to enact policies more consistent with the foreign policy preferences of sovereign creditors."<sup>54</sup> So a prudent policy would be to reduce the risk through reducing the impact of such hostile financial actions.

In addition to reducing the remote risk of external leverage on U.S. policy objectives, the second predominant reason that improved fiscal responsibility is required – and of interest to national security professionals – is that debt servicing costs will soon consume more of the available dollars in the overall U.S. budget. The continued spending for domestic needs will leave fewer resources for spending on military matters. Nye, in discussing the future of American power, is concerned with the impact of debt servicing on U.S. economic power. He believes that "a gradual increase in the cost of servicing the debt could affect the long-term health of the economy. It is in this sense that the debt problem is important."<sup>55</sup> The opportunity costs of servicing a debt of such magnitude are future economic competitiveness and fewer resources available elsewhere in the U.S. budget. National security spending will be squeezed out by debt servicing costs. The Office of Management and Budget has predicted that by 2018, the U.S. will spend \$800 billion to service its debt which will, for the first time, exceed the D.O.D. budget.<sup>56</sup> This decrease in available resources and arguable loss of power is not a direct consequence of China holding its share of U.S. debt, rather it is a consequence of the debt magnitude alone.

The third reason to improve U.S. fiscal responsibility is to set a better example globally. Improved fiscal discipline at home will translate into improved fiscal leadership internationally. The example set by U.S. economic power provides a basis to wielders of U.S. soft power. The U.S. remains the largest market for products from around the globe. The U.S. securities remain the most attractive place for foreign countries to place their surpluses. The recent trials of many European bond markets reinforce this point and increase the attraction of U.S. fiscal institutions to global capital sources. Improved U.S. fiscal responsibility would keep low the risk of future investment as measured by interest rates and further improve the attractiveness of U.S. markets and financial instruments. This continued attraction of global capital serves as a source of strength for U.S. soft power.

Therefore, this paper proposes three policy paths to improve U.S. fiscal responsibility and to mitigate the impact of the U.S. debt and China's holding of U.S. debt on its sovereign power. These paths will require discipline and restraint in the domestic arena and assumption of some risk in the international arena. But a rebalancing of domestic and foreign priorities will provide a foreign policy which is more consistent with what the American public is willing to sacrifice domestically for its international standing.

First and foremost amongst these policies is to "get serious" about reducing the U.S. debt. Curing the U.S. budget deficit addiction which has accumulated into \$14 trillion in debt is in the long term best interest of the U.S. The reasons are as much tied to domestic imperatives as gaining more financial independence from China.



The recent proposal tendered from the President's non-partisan National Commission Fiscal Responsibility and Reform provides a starting point for serious long-term debt reduction.<sup>57</sup> The proposal, introduced in November of 2010, did not achieve the required super-majority of panel members to go before the Congress, but it did muster 11 out of the 18 members' support. The proposal presents a serious initial effort to reduce the debt in the next 15-20 years through a combination of entitlement reductions, discretionary spending cuts and revenue increases. The proposal reduces the debt by \$4 trillion by 2020 and stabilizes debt to 60% of GDP by 2014 and 40% of GDP by 2024 – significant improvement over the 93% of GDP today. These estimates validate the proposal's suitability. The political responses from the U.S. left and right revealed the unpopularity of many of the elements of the proposal. But the balanced protests from both ends of the political spectrum demonstrate the seriousness and impartiality of the proposal. Further, pursuing this option would also demonstrate the self-discipline required of a world economic leader would restore a sizeable amount of influence globally even before the U.S. make measureable progress toward reducing its debt.<sup>58</sup> This demonstration of discipline and restored leadership at home would enable U.S. economic leaders to pursue more diverse trade agreements with nations other than China from a position of strength. It will be important that U.S. leadership keep the debate on reducing the debt atop the political agenda and muster the political courage to make real progress against the debt in the mid to long term.

The timing of such aggressive debt reduction is important and sensitive. The U.S. is only now emerging from the recent recession and only gradually as indicated by continued high unemployment rate. The debt reduction approach should allow for

continued growth in the short term to ensure a complete exit from the recession.

Focusing debt reduction on the medium and long term will provide the best approach to ensure a complete exit from the recession and address the imbalance between entitlement spending and revenues. But failing to present a plan exposes the U.S. to the risk of an external and unpredictable response from global capital markets. It will be important to preserve American power globally by remaining in a leadership position to resolve its debt burden or the loss of soft power will result.<sup>59</sup>

The second policy path which the U.S. must pursue is to share the burden and cost of its de facto global security leadership with other countries. Increasing and diversifying U.S. engagement with other global powers will be required to mitigate the risk associated with sharing the global security burden. Increasing trust amongst neighbor countries while still providing reassurance to countries in Asia will need to accompany sharing the global security functions that the U.S. provides. A wider multilateral approach in security matters will also mitigate the coming era of reduced spending on defense. The cost of autonomy is high, and is becoming increasingly unaffordable. The U.S. will need to accept some loss in autonomy as it decreases the risk and cost of bearing the global security burden alone.

U.S. DOD must prepare itself for more aggressive budget cuts than those planned by Secretary Gates. To truly address the scale of the U.S. debt, no aspect of government spending can be held sacrosanct. Michael O'Hanlon of the Brookings Institution cites defense budget cuts in the medium term as prudent strategic risks to take now "to protect our fundamental strength over the longer term."<sup>60</sup> As a consequence of reduced defense spending, U.S. foreign policy will be more restrained

than in recent years. Even though this restraint may be imposed by a decline in resources, it need not signal a decline in American power. Patrick Cronin from the Center for a New American Security proposes restraint as a means of recalibrating U.S. strategy. He goes so far as saying that the exercise of restrained U.S. power may be the best way to preserve American power and further global stability.<sup>61</sup> Michael Mandelbaum describes the future of U.S. power in one word: scarcity.<sup>62</sup> While the impact of fewer U.S. actions abroad will be a consequence of a more scarce application of U.S. power, he also hails the “discipline that scarcity will impose can actually improve the conduct of American foreign policy by precluding the kind of errors carelessness, itself the product of an abundance of power, produced in the first two post-Cold War decades.”<sup>63</sup> Such a restrained strategy with more scarce application of military power would also allow the U.S. to restore its economic foundations of strength. Leslie Gelb promotes a foreign policy reminiscent of Eisenhower and Truman where promotion of economic strength was the centerpiece of U.S. foreign policy.<sup>64</sup> Such an economically centered foreign policy would restore America’s economic power and hold military spending in check while bolstering its key allies.

A larger reliance on multilateral organizations and alliances must complement this restraint or scarcity. Deeper engagement of China in military and economic areas must also accompany the broader multilateral approach taken by the U.S. The opaque nature of China’s military modernization has been a source of the underlying anxiety in discussing China’s rise. As China also continues its military modernization and expands its naval activities in East Asia, an expanded multilateral approach will “be essential in convincing China to discuss military transparency.”<sup>65</sup> The reliance on a wider multilateral

approach to issues will thereby be essential to mitigate the scarce resources that a “frugal superpower” will have the ability to project.

Increased multilateral engagements in East Asia will provide benefits beyond just sharing the burden of global security leadership. It will promote trust between U.S. and China while also providing reassurance to nations in the region (e.g., India, S. Korea, Japan, Australia, etc.). This is partially a hedging strategy. Growing Chinese power in Asia makes many of its neighbors wary. This provides an opportunity for the U.S. Strong relations with other powers in Asia will balance these concerns in two ways: it will ensure China plays a “responsible role” in the region and “hedge against the possibility of aggressive behavior” in the region.<sup>66</sup> The U.S. has already shown moves in this direction. Both Presidents Bush and Obama’s trips to India in 2006 and 2010, respectively, have renewed and strengthened relations with India. A strong bilateral relationship with India on both security and economic grounds presents an effective balance to China in the region and complements the existing alliances with Japan and South Korea, Australia and New Zealand. Further, the democratic institutions which these balancing nations possess provide modest but measureable political pressure on China as it comes to grip with the “demands of increased political participation (if not democracy) that tend to accompany rising per capita income.”<sup>67</sup>

The third and final policy path to support the improvement of fiscal responsibility is the continued pursuit of more relaxed monetary policy in China, specifically, the revaluation of the RMB. U.S. economic policy makers should continue to pursue through the G20 and the WTO the means to pressure China to float the value of its currency. Notwithstanding the resent rebuff on this issue in November 2010 at the G20,

the President retains RMB revaluation as one of his objectives in the U.S.-China trade relationship. Any progress toward revaluation would benefit the U.S. in both the short and long term and make the challenge of improved fiscal responsibility more manageable. In the short term, rebalancing of the RMB to U.S. dollar would decrease the scale of the U.S. debt and the value of China's U.S. debt holdings in relative terms. In the longer term, the change in relative values of the U.S. dollar and Chinese RMB would depress the price of U.S. goods in Chinese markets and increase the price of Chinese goods in U.S. markets. An increase in Chinese domestic consumption of U.S. goods would begin to rebalance the historical U.S.-China trade imbalances. A currency revaluation would also deter U.S. Congressional leaders from imposing protectionist policies which would in turn weaken U.S. leadership in global economic community.

### Conclusion

China owns a significant fraction of the U.S. debt through its investments in U.S. Treasuries. China makes these dollar-based investments out of its own economic growth strategy and not explicitly to gain leverage over the U.S. in international affairs. Though it is feasible that a creditor such as China could gain leverage over the U.S. through its debt holdings, the likelihood of China doing so is low and even if China did seek such leverage it would be unlikely to be effective. The increasing interdependence of the global economy and especially the interdependence between the U.S. and China has driven the cost to China of such leverage seeking to a level that would jeopardize China's continued economic growth which sustains the Chinese Communist Party's hold on power. Nonetheless, the massive U.S. debt must be addressed albeit for reasons more tied to the opportunity cost of debt servicing than to reduce the risk of any creditor leveraging its holding of that debt. The scale of the U.S. debt coupled with

future federal spending obligations in the form of entitlements will, in the near future, incur increasing debt servicing costs which will crowd out other discretionary spending priorities and degrade the foundations of U.S. economic power. Therefore, the largest constraint to the exercise of U.S. sovereign power lies not abroad with China's U.S. debt holdings, but at home American propensity to spend beyond its ability to generate revenues. The U.S. must muster the political will to begin to address the scale of its debt and control the growth of future entitlements if it is to restore American economic strength for the decades ahead and relax its own constraints on U.S. sovereign power.

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